

## NOTES TO FINANCIAL STATEMENTS

### QUARTERS ENDED MARCH 31, 2004 AND 2003

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#### 1. BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

**Organization**—ConsumerHealth, Inc., dba Newport Dental (the “Company”), was incorporated in California in December 1979 to provide marketing and administrative services to independent dentists. In June 1985, the California Department of Managed Health Care (“DMHC”), under the Knox-Keene Health Care Service Plan Act of 1975, licensed the Company as a dental plan. As of March 31, 2004, the Company owns and operates a network of 15 staff model dental facilities that offer a full range of routine general dental services and specialty dental services, such as orthodontics, periodontics and oral surgery. Additionally, the Company contracts with approximately 375 independent general dentists and 339 independent specialty dentists to provide services to its plan members. The Company is licensed to operate in Los Angeles, Orange, Riverside, San Bernardino, San Diego, Alameda, Contra Costa, Fresno, Sacramento, San Francisco, San Joaquin, San Mateo, Santa Clara, Sonoma and Stanislaus counties. As of March 31, 2004 and 2003, there were approximately 67,538 and 51,694 enrollees, respectively, in the dental plan (unaudited).

The Company is a wholly owned subsidiary of Bright Now! Dental, Inc. (“Bright Now!” or the “Parent”), a company that provides administrative services to general dental and orthodontic practices throughout the United States, in addition to its relationship with the Company. The Company has various transactions with the Parent recorded through intercompany accounts. The amount of such transactions may not necessarily be indicative of the amounts that the Company would have incurred if the Company had been operated as an unaffiliated entity.

**Basis of Presentation**—The accompanying financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America.

**Use of Estimates**—The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

**Accounts Receivable**—The Company extends credit to patients, without collateral, in the normal course of business for terms of up to 18 months.

Due to the nature of the industry and the environment in which the Company operates, certain estimates are required to record accounts receivable at their net realizable values. Inherent in these estimates is the risk that they will have to be revised or updated as additional information becomes available. Accounts receivable are reduced by an allowance for doubtful accounts, which provides for those accounts from which payment is not expected to be received, although services were provided and revenue was earned.

Management performs periodic analyses to evaluate accounts receivable balances to ensure that recorded amounts reflect estimated net realizable value. Specifically, management considers historical realization data, accounts receivable aging trends, other operating trends and relevant business conditions. Due to continuing changes in the health care industry and third-party reimbursement, it is possible that management’s estimates could change in the near term, which could have an impact on operations and cash flows.

**Supplies**—Supplies consist of dental and orthodontic supplies, which are stated at lower of cost or market, with cost determined by the first-in, first-out (FIFO) method.

**Property and Equipment**—Property and equipment are stated at cost, less accumulated depreciation. Depreciation is calculated using the straight-line method over the estimated useful lives of the individual assets as follows:

Equipment	3 to 10 years
Furniture and fixtures	5 to 10 years
Leasehold improvements	Shorter of lease term or estimated useful life, generally 5 to 10 years

**Goodwill**—Goodwill relates to the purchase of all of the Company's outstanding stock in August 1998 by the Parent and represents the excess of the purchase price over the value of the net assets acquired. Prior to 2002 and before the adoption of Statement of Financial Accounting Standards ("SFAS") No. 142, *Goodwill and Other Intangible Assets*, goodwill was being amortized on a straight-line basis over the period of expected benefit, determined to be 25 years. Previously, management reviewed for impairment on an ongoing basis and whenever events or changes in circumstances indicated the possibility of impairment. In accordance with SFAS No. 142, goodwill is no longer amortized but tested annually for impairment, or more frequently if circumstances indicate impairment. Upon the Company's adoption of SFAS No. 142 in its entirety on January 1, 2002, the amortization of goodwill ceased.

**Restricted Cash**—Restricted cash consists of a certificate of deposit whose use is restricted by the DMHC deposit requirements for Knox-Keene licensees.

**Long-Lived Assets**—Management reviews for impairment of long-lived assets on an ongoing basis and whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable, based on estimated future cash flows. Management does not believe any impairment of its long-lived assets existed at March 31, 2004.

**Deferred Rent**—Deferred rent totaling \$98,000 represents rental expense recorded on a straight-line basis in excess of actual rent payments and is included in other long-term liabilities.

**Revenue Recognition, Health Care Costs and Concentration of Credit Risk**—Dental revenue is recognized as services are provided and reported at the estimated net realizable amounts from patients, third-party payors and others for services rendered. Premium revenue is recognized in the month in which enrollees are entitled to receive dental care services and premiums are billed in advance on a monthly, quarterly or annual basis. Orthodontic revenue is recognized on the proportional performance method based on the ratio of costs incurred to the total estimated costs over the life of an orthodontic contract. The Company has agreements with various Dental Maintenance Organizations ("DMO") to provide dental services to subscribing participants. Under these agreements, the Company receives monthly capitation payments based on the number of DMO enrollees assigned to the Company. The Company is then responsible to provide the necessary dental services and collect any appropriate copayment from the enrollee. Revenues are recognized in the month that the Company is obligated to provide care. Health care costs are expensed as services are rendered, including estimates of the costs of services rendered by independent contracted dentists but not yet reported, which are not significant.

Approximately 12% and 18% of the Company's revenues were attributable to Medicaid for the quarters ended March 31, 2004 and 2003, respectively. To qualify for payments under this program, the Company must follow certain procedures and guidelines outlined in a provider handbook. For the quarters ended March 31, 2004 and 2003, no other third-party payor represented 10% or more of the Company's revenues. Premium revenues derived under capitation arrangements represented approximately \$695,000 and \$653,000 for the quarters ended March 31, 2004 and 2003, respectively.

***Administrative Services Agreement***—Bright Now! provides the Company with certain administrative and management services, including financial, accounting, operational, marketing, clerical, information systems, human resources, purchasing and facility management. The nature and extent of such services are governed by an Administrative Services Agreement (the "ASA") between the parties. Under the terms of the ASA, the Company reimburses Bright Now! for all direct costs and expenses that Bright Now! pays on behalf of the Company. In addition, the Company pays Bright Now! an administrative services fee for providing such services. Administrative services fees, which are included in dental services and general and administrative expense, were approximately \$363,000 for the quarters ended March 31, 2004 and 2003. The amount of such fees may not necessarily be indicative of the amounts that the Company would have incurred if the Company had been operated as an unaffiliated entity.

***Advertising Expense***—The Company obtains all of its advertising and marketing services under the terms of the ASA. The administrative services fee described in the preceding paragraph includes the cost related to advertising.

***Income Taxes***—The Company accounts for income taxes under the provisions of SFAS No. 109, *Accounting for Income Taxes*. Under this method, deferred income tax assets and liabilities are computed for differences between the financial statement and tax bases of assets and liabilities based on enacted tax laws and rates applicable to the periods in which differences are expected to affect taxable income. Valuation allowances are established, when necessary, to reduce deferred tax assets to amounts that are, more likely than not, estimated to be realized.

Through the ASA, the Company has entered into a tax sharing arrangement that provides for the Company to reimburse Bright Now! for all income taxes due, if any, had the Company filed tax returns on a stand-alone basis.

***Reclassifications***—Certain prior year amounts may have been reclassified to conform to the current year presentation.

## **2. KNOX-KEENE HEALTH CARE SERVICE PLAN ACT OF 1975**

The Company is licensed by the State of California under the provisions of the Knox-Keene Health Care Service Plan Act of 1975, which requires the Company to maintain certain amounts of specific cash reserves, tangible net equity, and other financial reporting and regulatory requirements as defined. Management believes that the Company is in compliance with all such requirements at March 31, 2004.

### 3. PROPERTY AND EQUIPMENT

Property and equipment consist of the following as of March 31 (in thousands):

	2004	2003
Office furniture and dental equipment	\$ 4,666	\$ 4,674
Leasehold improvements	<u>1,459</u>	<u>1,399</u>
Total property and equipment	6,125	6,073
Less accumulated depreciation	<u>(5,342)</u>	<u>(5,270)</u>
Property and equipment—net	<u>\$ 783</u>	<u>\$ 803</u>

### 4. TRANSACTIONS WITH RELATED PARTIES

On August 12, 1997, the Company entered into a five-year operating lease with one of its officers and commenced payments according to lease terms. The original lease expired August 31, 2003 and provided for two 18-month options, both of which have been exercised by the Company. The second option expires August 31, 2005. Payments under the lease are approximately \$5,600 per month.

The Company has an ASA with the Parent under which the Parent provides the Company with certain administrative and management services (see Note 1).

### 5. INCOME TAXES

The federal and state income tax provision is summarized as follows for the quarters ended March 31 (in thousands):

	2004	2003
Current expense:		
Federal	\$ 188	\$ 24
State	<u>53</u>	<u>5</u>
Total current expense	<u>241</u>	<u>29</u>
Deferred (benefit) expense:		
Federal	(8)	67
State	<u>(2)</u>	<u>19</u>
Total deferred (benefit) expense	<u>(10)</u>	<u>86</u>
Total income tax provision	<u>\$ 231</u>	<u>\$ 115</u>

Income tax expense differs from the amount obtained by applying the statutory federal income tax rate of 34% to income from operations as follows for the quarters ended March 31 (in thousands):

	<b>2004</b>	<b>2003</b>
Provision at statutory federal income tax rate	\$ 198	\$ 95
California franchise tax—net of federal benefits	33	22
Other	<u>-</u>	<u>(2)</u>
Total income tax provision	<u>\$ 231</u>	<u>\$ 115</u>

Deferred income taxes reflect the tax effects of temporary differences between the bases of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of the Company's deferred tax assets and liabilities are as follows as of March 31 (in thousands):

	<b>2004</b>	<b>2003</b>
Deferred tax assets:		
Allowance for bad debts	\$ 306	\$ 162
Accrued payroll expenses	63	41
Depreciation	98	95
Other	<u>80</u>	<u>7</u>
Total deferred tax assets	<u>547</u>	<u>305</u>
Deferred tax liabilities:		
Deferred orthodontics revenue	(461)	(357)
Deferred state taxes	<u>(1)</u>	<u>4</u>
Total deferred tax liabilities	<u>(462)</u>	<u>(353)</u>
Net deferred tax asset (liability)	<u>\$ 85</u>	<u>\$ (48)</u>

As of March 31, 2004, no valuation allowance has been provided based upon the Company's assessment of future realizability of certain deferred tax assets, as it is more likely than not that sufficient taxable income will be generated to realize these temporary differences.

## 6. COMMITMENTS AND CONTINGENCIES

**Lease Obligations**—The Company leases certain of its facilities under noncancelable operating leases that expire in various years through 2013. Several leases contain options for renewal and rent escalation clauses generally based upon certain consumer price indices. Future minimum lease payments under noncancelable operating leases at March 31, 2004 are as follows (in thousands):

<b>Quarter Ended March 31</b>	
2004	\$ 765
2005	1,065
2006	1,020
2007	949
2008	703
Thereafter	<u>2,517</u>
Total minimum lease payments	<u>\$ 7,019</u>

Rental expense for the quarters ended March 31, 2004 and 2003 was approximately \$285,000 and \$270,000, respectively.

**Litigation**—From time to time, the Company has been a party to professional liability claims and other litigation arising in the ordinary course of business. In the opinion of management, any liability beyond amounts covered by insurance, and the ultimate resolution of all pending legal proceedings, will not have a material adverse effect on the Company's financial performance or results of operations.

**Regulatory Matters**—Laws and regulations governing Medicaid programs are complex and subject to interpretation. Compliance with such laws and regulations can be subject to future governmental review and interpretation, as well as significant regulatory action including fines, penalties and exclusion from certain governmental programs. The Company is not aware of any pending or threatened investigations involving allegations of potential wrongdoing.

A portion of the Company's revenues is derived from Medicaid, for which reimbursement rates are subject to regulatory changes and government funding restrictions. Although the Company is not aware of any significant future rate changes, significant changes to the reimbursement rates could have a material effect on the Company's operations.

**Insurance Coverage**—The Company maintains an extensive risk management plan that includes general liability, professional liability, directors' and officers' liability, employment practices liability, property, crime, business interruption, automobile, earthquake, flood, workers' compensation, employer liability and employee benefits liability insurance. In addition, the Company maintains a \$10,000,000 umbrella excess liability policy over the primary general liability, automobile and employer's liability coverages.

The Company's policy for professional liability coverage is written on a "claims made" basis with limits of \$1,000,000 per occurrence and \$3,000,000 in the aggregate and a \$40,000 aggregate deductible. This policy is in effect through October 31, 2004, and management intends to renew the policy on that date for one year for the same coverage. The Company has accrued \$41,000 and \$16,000 as of March 31, 2004 and 2003, respectively, for unpaid and incurred but not reported claims. Amounts accrued are included in other liabilities in the accompanying financial statements.

***Guarantees and Indemnities***—From time to time the Company enters into certain types of contracts that contingently require the Company to indemnify parties against third-party claims. These contracts primarily relate to (i) certain real estate leases, under which the Company may be required to indemnify property owners for environmental or other liabilities and other claims arising from the Company's use of the applicable premises; and (ii) certain agreements with the Company's officers, directors and employees, under which the Company may be required to indemnify such persons for liabilities arising out of their employment relationship.

The terms of such obligations vary by contract and in most instances a specific or maximum dollar amount is not explicitly stated therein. Generally, obligation amounts under these contracts cannot be reasonably estimated until a specific claim is asserted. No new guarantees or indemnifications were issued in 2003. Consequently, no amounts have been accrued for these obligations on the Company's balance sheets for any of the periods presented.

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